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In the Supreme Court of the United States

OCTOBER TERM, 1961

No. 255

UNITED STATES, PETITIONER

v.

DON GILMORE AND SUE GILMORE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

No. 256

UNITED STATES, PETITIONER

v.

TALBOT PATRICK, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the Court of Claims in *United States v. Gilmore* (G.R. 112–125) [1] is reported as 290 F. 2d

[1] References to the record in *United States v. Gilmore*, No. 255, are prefixed "G.R.": references to the record in *United States v. Patrick*, No. 256, are prefixed "P.R."

942. The opinion of the district court in *United States* v. *Patrick* (P.R. 46–52) is reported at 186 F. Supp. 48, and the opinion of the court of appeals (P.R. 59–67) is reported at 288 F. 2d 292.

JURISDICTION

The judgment of the Court of Claims in *Gilmore* was entered on June 7, 1961 (G.R. 112, 125). The judgment of the court of appeals in *Patrick* was entered on March 27, 1961 (P.R. 68). On June 24, 1961, by order of the Chief Justice, the time for filing a petition for a writ of certiorari in *Patrick* was extended to and including July 25, 1961. The government's petitions for writs of certiorari in both cases were filed on July 25, 1961, and were granted on October 9, 1961 (G.R. 145, 368 U.S. 816; P.R. 69, 368 U.S. 817). The jurisdiction of this Court in *Gilmore* rests on 28 U.S.C. 1255(1), and in *Patrick*, on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. In *United States* v. *Gilmore* and *United States* v. *Patrick:*

Whether the portion of a taxpayer-husband's legal expenses, allocable to the property-settlement aspect of a divorce proceeding,[2] are deductible, for income tax purposes, on the theory that they are "ordinary and necessary expenses paid * * * for the management, conservation, or maintenance of property held

[2] In *Gilmore*, the taxpayer-husband paid the legal fees for services rendered in contesting his wife's divorce action, while, in *Patrick*, the taxpayer-husband paid the legal fees for services rendered in negotiating and effectuating the property-settlement agreement.

for the production of income," within the meaning of Section 23(a)(2) of the Internal Revenue Code of 1939 and Section 212(2) of the Internal Revenue Code of 1954.[3]

2. In *United States* v. *Patrick:*

Whether the taxpayer-husband, having been directed by the divorce court to pay, and having paid, legal fees owed by the wife to her attorney for similar services, may deduct those fees under Section 212(2) of the 1954 Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Codes and the Treasury Regulations are set forth in the Appendix, *infra,* pp. 43–46.

STATEMENT

United States v. *Gilmore, No. 255*

The pertinent facts, as found by the Court of Claims (G.R. 125–144), may be summarized as follows:

Don Gilmore (the taxpayer) and Dixie Gilmore were married in 1946.[4] They had no children. In April 1952, they separated, and Mrs. Gilmore filed suit for divorce in California, charging her husband with extreme cruelty and adultery. In June of that

[3] In *Gilmore*, both the 1939 and 1954 Codes are applicable because the taxable years involved are 1953, 1954 and 1955; in *Patrick*, only the 1954 Code is applicable because the taxable year involved is 1956.

[4] Sue Gilmore, a party to this proceeding, is the taxpayer's second wife, whom he married on November 1, 1955. She and the taxpayer filed a joint income tax return for 1955. (G.R. 125, 139.)

year, Mr. Gilmore filed an answer and a cross-complaint for divorce, alleging extreme cruelty by Mrs. Gilmore. (G.R. 125–126, 132.)

In the divorce proceedings, Mrs. Gilmore made a claim with respect to the taxpayer's principal income-producing property. The property consisted of holdings in three automobile dealerships which the taxpayer had acquired prior to his marriage.[5] The stockholdings had increased in value by $600,000 (from $200,000 to $800,000) between 1946 and 1952. Mrs. Gilmore claimed that this increment was community property under the laws of California. Prior to the divorce trial, Mrs. Gilmore had offered to take $275,000 in full settlement of her claim, but the taxpayer rejected the offer because he feared that a settlement might result in a cancellation of his dealership franchises and because his attorneys had advised him that the increment in the value of his holdings was separate property. (G.R. 130–131.)

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[5] The taxpayer's stockholdings were as follows: 100 percent of the outstanding shares of Don Gilmore-San Francisco; 60 percent of the outstanding shares of Don Gilmore-Riverside; and 73⅓ percent of the outstanding shares of Don Gilmore-Hayward. Each of these enterprises was a California corporation which operated as a franchised automobile dealer of a division of the General Motors Corporation. During the taxable years, and for many years previously, the taxpayer was the president and principal managing officer of each of the corporations. He derived substantial income in the form of salaries and dividends from the corporations, largely due to his ownership and control. During 1953 and 1954, the taxpayer's only income from sources unrelated to the corporations was $1,024.90 and $516.60, respectively. He had spent all of his adult life in the retail automobile business, which was the only business he knew. (G.R. 127–129.)

At the divorce trial, most of the evidence presented by the parties was devoted to the alleged misconduct. Some, though considerably less, testimony was directed to the question whether the increase in the value of the taxpayer's stock in the automobile dealerships was community property.* After Mrs. Gilmore took the initiative in presenting evidence of misconduct, Mr. Gilmore's attorneys considered it necessary to resist those charges by extensive cross-examination and by evidence of misconduct on Mrs. Gilmore's part. This was undertaken because (1) under California law, the court must award more than 50 percent of the community property, and may award all of it, to the innocent spouse in divorces based on extreme cruelty or adultery; (2) Mrs. Gilmore's charges of misconduct were published in the local newspapers, and it was feared that General Motors might cancel the taxpayer's dealership franchises if the allegations were proved; (3) the credibility of the parties became an important factor, and the taxpayer's attorneys feared that, if the trial judge believed Mrs. Gilmore's account, he might also find that there was community property and award all or most of it to her; and (4) there was presented an issue whether oral declarations and conduct between the parties had affected the nature of the property in dispute. (G.R. 132–133.)

* Other issues presented were whether Mrs. Gilmore was entitled to alimony and whether two houses in which the parties had lived were held in joint tenancy. The taxpayer's attorneys devoted little time and effort to these issues. (G.R. 133.)

In 1953, after trial, the Superior Court found the issues in favor of the taxpayer, granting him an interlocutory divorce, denying Mrs. Gilmore a divorce, and holding that there was no community property of the marriage. On October 25, 1955, after an appeal, a remand of the case, and further proceedings in which the Supreme Court of California affirmed the interlocutory judgment of the Superior Court, a final judgment of divorce in favor of the taxpayer was entered in the trial court.[1] (G.R. 126.)

As a result of the protracted litigation, the taxpayer was required to pay a total of about $45,911.36 in legal fees for the years 1953, 1954 and 1955 ($32,537.15 for 1953; $8,074.21 for 1954; and approximately $5,300 for 1955). In his income tax returns for 1953 and 1954 (the years here involved), the taxpayer deducted a substantial portion of the legal fees as an expense incident to defending properties and investments. The Commissioner disallowed the deductions on the ground that the legal fees were personal expenditures and therefore nondeductible under Section 24(a)(1) of the Internal Revenue Code of 1939 (App., *infra*, p. 43). The deficiencies were paid and this suit for refund followed. (G.R. 134–136, 138, 140, 141–142.)

In the proceedings below, taxpayer claimed, and the Court of Claims held (R. 112–120), that 80 percent of of his legal fees were deductible under Section 23(a)(2) of the Internal Revenue Code of 1939 (App., *infra*, p. 43) as having been incurred in the conserva-

[1] The two residences were held to be property held in joint tenancy (R. 126).

tion of his income-producing property" (G.R. 119).[8] The court stated that "plaintiff was fighting not only to protect his income-producing property, but to prevent the loss of his salary as well" (G.R. 117), and then observed (G.R. 119) that

> * * * in every divorce case a certain amount of legal expenses are incurred for the purpose of obtaining the divorce and a certain amount are incurred in an effort to conserve the estate and are not necessarily deductible under section 23(a)(2), but when the facts of a particular case clearly indicate that the property, around which the controversy evolves, is held for the production of income and without this property the litigant might be denied not only the property itself but the means of earning a livelihood, then it must come under the provisions of section 23(a)(2) * * *.

United States v. *Patrick, No. 256*

Talbot Patrick, the taxpayer,[9] was sued for divorce by his then wife, Paula M. Patrick, on December 16, 1955, in the Court of Common Pleas for York County, South Carolina. In her complaint, Paula sought an absolute divorce, court supervision of division of the properties, an appropriate property settlement, cus-

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[8] The remaining 20 percent was allocated to obtaining the divorce as distinguished from protecting the property.

[9] The word "taxpayer" is used to refer only to Talbot Patrick, although the administrator of the estate of his second wife, Alethia M. Patrick, is a party to this suit because the income tax return for the year in question, 1956, was filed on a joint return basis (P.R. 46).

tody of the minor children, and attorneys' fees. The taxpayer, in his answer to Paula's claim, neither admitted nor denied the alleged grounds for divorce (adultery) and he did not testify at the hearing during the course of the divorce action. The divorce court subsequently issued a final decree of absolute divorce, approved the property settlements made by the parties in an "Amended Stipulation and Agreement", and, by reference, required the payment by taxpayer of attorneys' fees. (P.R. 7, 46–47.)

The "Amended Stipulation and Agreement" (P.R. 7–14), which incorporated the parties' property settlement agreement, was the result of extended negotiations between counsel for both parties while the divorce action was pending (P.R. 47). Since adultery is a ground for absolute divorce in South Carolina and the taxpayer made no defense, the wife was entitled to a substantial property settlement (P.R. 49).

The property settlement agreement provided for payments by taxpayer for the support and maintenance of the parties' children (P.R. 9–11) and contained provisions relating to specific property. The taxpayer and his wife were each to receive one of the two family residences (P.R. 8). Although they jointly owned various properties (P.R. 4), the only income-producing property covered by the agreement consisted of (1) stock in the Herald Publishing Company, of which the taxpayer was president and treasurer (as well as editor and publisher of its newspaper), and (2) a parcel of real estate which was in part leased and used by the publishing company (P.R. 3, 4, 11).

The stock of the publishing company had all been owned or held in trust for members of the taxpayer's family. The taxpayer owned 28 percent of the stock; his wife, 28 percent; and their adult son Hugh, 9 percent. In addition, 7 percent was in a trust fund for Hugh, and a 14 percent interest was in each of two other trust funds for the benefit of each of two minor children, Wayne and Paula. (P.R. 4.)

The wife and her attorneys were satisfied with the taxpayer's management of the corporation and the editorial position of the newspaper (P.R. 50–51). They considered that the wife's best interests would be served if the taxpayer continued to control and manage the corporation (R. 51). The wife made no immediate threats upon the taxpayer's operation or control of the newspaper and did not seek to enjoin the alienation or encumbrance of his interest; nor did she question his right, title or interest in the corporate shares (P.R. 23–24, 28, 32, 37–38, 43–46). The property settlement agreement provided that the taxpayer would purchase his wife's 28 percent interest in the publishing company and that the stock would pass to the children upon his death or that, if the interest were sold, the proceeds would become the property of the children (P.R. 5, 11–12).

The real estate expressly covered by the property settlement agreement was located on West Main Street in Rock Hill, South Carolina. Prior to the agreement, the taxpayer had an 80 percent undivided interest in this property, which was in part leased to, and used by, the Herald Publishing Company, and his wife had a 20 percent undivided interest. (P.R. 4.)

Under the property settlement agreement, both taxpayer and his wife's interests in this property were to be placed in a trust, the property was to be leased to the Herald Publishing Company for ten years (with options for renewal), and the net income of the trust was to be paid to the wife for life and then to the children. The trust was to terminate when the youngest child reached the age of 21, at which time the property was to be conveyed to the children. (P.R. 5, 8–10.)

The attorneys' fees incurred by each party, relating to the divorce action and accompanying settlement agreement, were $12,000, a total of $24,000. Pursuant to the settlement agreement and divorce decree, the taxpayer paid the entire amount.[10] By agreement between counsel and the parties, the total fees of $24,000 were allocated as follows: $4,000 for the handling of the divorce; $4,000 for the handling of the real estate property—$3,200 charged to the taxpayer and $800 to the wife, in proportion to their prior 80 and 20 percent ownership; and $16,000 for the handling of the interests in the Herald Publishing Company. (P.R. 47.)

The district court held that the taxpayer was entitled to deductions in 1956, totaling the $19,200 claimed, which covered (1) the $16,000 in attorneys' fees paid by the taxpayer to his own and his wife's attorneys for handling the settlement in relation to the

[10] The publishing company paid $16,000, but the taxpayer later repaid this amount to the company. The district court held that the company's payment was a loan to the taxpayer (P.R. 48). The government did not appeal this ruling.

parties' interests in the Herald Publishing Company and (2) the $3,200, which was the taxpayer's share of the $4,000 allocated to the settlement of the real estate property (P.R. 46–52).

The court of appeals affirmed (P.R. 59–67). In the course of its opinion, the court admitted that "[t]he wife made no immediate threat" to the taxpayer-husband's specific "income-producing property" (P.R. 61, 65), but nevertheless went on to hold that "the legal fees incurred by the taxpayer in maintaining and conserving his income-producing property are deductible under [the 1954] Code Section 212(2) [App., *infra*, p. 44]" (P.R. 66). The court stated (P.R. 65):

> It is true the wife, in this case, did not commit an overt act, to either enjoin, damage or encumber the taxpayer's income-producing property. This was not necessary. We conclude that all of the taxpayer's income-producing properties were in great peril until and unless a satisfactory settlement agreement was concluded.

SUMMARY OF ARGUMENT

I

The present cases sharply illustrate the proposition that the adjustment of intra-familial obligations arising out of the termination of the marriage relationship is typically a matter far removed from the "ordinary and necessary expenses paid * * * for the management, conservation, or maintenance of property held for the production of income * * *," the subject matter of Section 23(a)(2) of the Internal Revenue Code

of 1939 and Section 212(2) of the Internal Revenue Code of 1954. Contrary to the courts below, the government contends, that a husband's legal expenses allocable to the property-settlement aspect of a divorce proceeding are not deductible because they do not come within the coverage of Sections 23(a)(2) and 212(2) but are instead "personal, living, and family" expenses within the meaning of Section 24(a)(1) of the 1939 Code and Section 262 of the 1954 Code.

A. Ever since the first income tax law was enacted in 1913, the various Revenue Acts have drawn a distinction between "business" and "personal" expenses. Prior to 1942, only "the ordinary and necessary expenses paid or incurred * * * in carrying on any trade business" were deductible (Section 23(a)(1)(A) of the 1939 Code). Expenses incurred in nontrade or nonbusiness profit-seeking activities were considered by this Court as not being deductible because they had not been "paid or incurred * * * in carrying on any trade or business." To correct this rule which it believed inequitable, Congress added, in 1942, the present subsection (a)(2) to Section 23 to provide for a class of deductions for expenses incurred in nontrade and nonbusiness profit-seeking activities which were to be "coextensive with the business deductions allowed by § 23(a)(1), except for" the requirement that the expenses be incurred in a "trade or business" (*Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 374). With this one exception, deductions under subsection (a)(2) were to be subject to *all* the restrictions and limitations which applied to deductions under subsection (a)(1)(A). Under no

circumstances did the new subsection "authorize widespread deductibility of personal, living or family expenditures" (*Lykes* v. *United States*, 343 U.S. 118, 122). The expenses for which deductions were authorized under Section 23(a)(2) were therefore more akin to "business" expenses in the nontechnical sense than to "personal" expenses, and Section 23(a) as a whole retained its original character as a provision for the deduction of "business"—or at least "business"-type—expenses. The same language of Section 23(a)(2) was carried over into Section 212 of the 1954 Code.

B. According to the tests established by this Court, the deductibility of legal expenses turns upon the nature of the activities to which the legal expenses relate and upon the origin and immediate purpose of the expenses. The legal expenditures must be an expense of a profit-seeking activity and must be incurred in, or arise or grow out of, the conduct of that activity. The expenditures cannot be merely an incidental cause of, or make a remote contribution to, the conservation or maintenance of income-producing property. Thus, it is clear that legal expenses incurred during the course of a divorce proceeding—whether they be to contest the divorce, to resist the liability for alimony, or to negotiate a property settlement—are not "ordinary and necessary expenses paid * * * for the * * * conservation * * * or maintenance of property held for the production of income" (Section 23(a)(2) of the 1939 Code). Although the legal expenses may minimize the material effects of the divorce by holding to a mini-

mum the amount necessary to effectuate the property settlement, the protection of the property is merely the incidental effect of the expenses. The origin and immediate purposes of the expenses do not arise out of the conduct of the husband's profit-seeking activity. Rather, their origin is in the marital rift or termination of the marital relationship, an obviously "personal" or "family" matter.

C. In holding that the legal expenses incurred by a husband in connection with the property-settlement aspect of a divorce proceeding were deductible under Section 23(a)(2) of the 1939 Code and Section 212(2) of the 1954 Code, the courts below purported to follow a line of authority which originated with *Baer* v. *United States*, 196 F. 2d 646 (C.A. 8th). The test adopted by the court in *Baer*, and by the courts which have followed *Baer*, may be articulated in the following way: although legal expenses connected with a divorce proceeding are ordinarily nondeductible as "personal" expenses, they nevertheless may be deducted as "ordinary and necessary expenses paid" for the "conservation" or "maintenance" of income-producing property, provided that (1) the husband does not contest the divorce and (2) concedes his liability for alimony, but incurs the legal expenses, (3) because of the urgency of resisting his wife's demands (4) with respect to specific income-producing property (5) out of which he earns his livelihood, in order to arrive as a satisfactory adjustment of his liability in a property settlement.

The basic flaw in the *Baer* test is that it fails to distinguish between the incidental effect of the legal ex-

penditures on the conservation or maintenance of the husband's position with respect to his specific income-producing property and the origin of the legal expenses which is in the marital rift and divorce.

The second basic error in the *Baer* test is that it emphasizes the urgency of resisting the wife's demands even though this Court in *Lykes* v. *United States, supra,* 343 U.S. at 125, noted that neither the "size" of the liability nor the "urgency" of resisting it "determined its character."

Baer also erroneously distinguishes between the husband's expenditure of legal fees in order to protect specific income-producing property out of which he earns his livelihood, which is considered deductible, and the husband's expenditure of legal fees in order to protect his general assets by holding to a minimum the amount necessary to effect a property settlement, which is considered not deductible. But in *Lykes* (343 U.S. at 126), this Court looked with displeasure on the "substantial uncertainty and inequity [which] would inhere" in such a distinction.

Finally, *Baer* attempts to draw an impracticable line of demarcation between what is and what is not deductible, which can only engender confusion in its application. Thus in *Gilmore,* the Court of Claims, though relying on *Baer,* allowed the taxpayer a deduction of 80 percent of the legal expenses he incurred in contesting both the divorce and his liability for the settlement of property, while in *Patrick* the Fourth Circuit went off in the opposite direction in relying on *Baer* but applying it to a completely amicable divorce and property setlement in which there was no

immediate threat by the wife to any specific income-producing property and in which even the incidental effect of the legal fees had no relevance to the "conservation" or "maintenance" of income-producing property.

D. Even if the personal nature of the contested legal expenditures were to be ignored, a portion of the expenditures in *Gilmore* and all of the expenditures in *Patrick* would be nondeductible as being capital in nature. In *Gilmore,* to whatever extent the legal expenses were attributable solely to contesting the wife's claim that the $600,000 appreciation in value of the taxpayer's stockholdings in his automobile dealerships was community property, the legal expenses were incurred in the defense of title to property and were therefore nondeductible capital expenditures. On the other hand, under the property-settlement agreement in *Patrick,* the husband relinquished his 80 percent undivided interest in the real estate, retained his 28 percent stock interest in the publishing company, and purchased his wife's 28 percent stock interest in the company. If the negotiation had been considered an arms length transaction, the expenses of acquiring and disposing of the property would have been considered capital in nature and therefore nondeductible except as an offset in computing gain on the disposition of the property involved.

II

The court in *Patrick* so completely misconceived the language and purpose of Section 212(2) of the 1954 Code that it even allowed the taxpayer to deduct

the attorneys' fees which his wife incurred in relation to the rearrangement of the stock interest in the publishing company, and which the taxpayer became obligated to pay under the property settlement incorporated in the divorce decree. All the reasons for disallowing the deductions for the taxpayer's own attorneys' fees are equally applicable to his wife's attorneys' fees. Indeed, since the wife was the taxpayer's adversary in the divorce proceedings and employed the attorneys to protect her own interest, her attorneys' fees could hardly have been incurred for the purpose of conserving or maintaining the taxpayer's own income-producing property. Actually, of course, the payment of the wife's fees was a part of what the taxpayer paid in satisfaction of his liability to his wife by virtue of the divorce, which was akin to alimony, but not deductible as such, because the fees were not in the form of periodic payments.

ARGUMENT

I

THE LEGAL EXPENSES INCURRED BY A HUSBAND IN CONNECTION WITH THE PROPERTY-SETTLEMENT ASPECT OF A DIVORCE PROCEEDING ARE NOT DEDUCTIBLE, FOR INCOME TAX PURPOSES, AS HAVING BEEN PAID FOR THE CONSERVATION OR MAINTENANCE OF INCOME-PRODUCING PROPERTY WITHIN THE MEANING OF SECTION 23(a)(2) OF THE INTERNAL REVENUE CODE OF 1939 AND SECTION 212(2) OF THE INTERNAL REVENUE CODE OF 1954

Both courts below held that a husband may deduct that portion of his legal expenses allocable to the property-settlement aspect of a divorce proceeding, on the theory that the legal expenses are "ordi-

nary and necessary expenses paid * * * for the management, conservation, or maintenance of property held for the production of income * * *" within the meaning of Section 23(a)(2) of the Internal Revenue Code of 1939 (App., *infra*, p. 43) and its counterpart in the Internal Revenue Code of 1954, Section 212(2) (App., *infra*, p. 44). The government contends that these legal expenses are not deductible because they do not come within the coverage of Sections 23(a)(2) and 212(2) but rather are "'personal' living and family expenses" within the meaning of Section 24(a)(1) of the 1939 Code (App., *infra*, p. 43) and Section 262 of the 1954 Code (App., *infra*, p. 44). See Treasury Regulations 118, Sec. 39.24(a)-1, App., *infra*, p. 45; Treasury Regulations on Income Tax (1954 Code), Sec. 1.262-1(b)(7), App., *infra*, p. 46).[11] The present cases sharply il-

[11] The Treasury Regulations make one exception to the general rule that attorneys' fees paid in a suit for divorce or separate maintenance are not deductible, *i.e.*, the part of an attorney's fee which is properly attributable to the production or collection of periodic payments of alimony, which are includible in the gross income of the wife under Section 22(k) of the 1939 Code and Section 71 of the 1954 Code. This alimony income generally would be taxable to the husband instead of the wife if it were not for Sections 22(k) and 71. See *Douglas* v. *Willcuts*, 296 U.S. 1; *Commissioner* v. *Lester*, 366 U.S. 299. In this situation the attorneys' fees are incurred in the conduct of a profit-seeking activity, and allowance of the deduction is consistent with the Congressional policy of allowing a deduction for the expenses of producing taxable income. It is noteworthy that the deduction is not for all the wife's attorneys' fees, nor even for all of her attorneys' fees for services related to a property settlement; it is only for those fees which are allocable to the periodic payments of alimony which are taxed to the wife.

lustrate the proposition that the adjustment of intra-familial obligations arising out of the termination of the marriage relationship is typically a matter far removed from the ordinary and necessary expenses of engaging in profit-seeking activities implicit in the holding of property for the production of income—the subject matter of Section 23(a)(2) of the 1939 Code and Section 212(2) of the 1954 Code. The present cases also show how far the courts below have gone in misconceiving or ignoring the language and purpose of the statutes involved.

A. ONLY ORDINARY AND NECESSARY EXPENSES INCURRED IN CARRYING ON, OR ENGAGING IN, A PROFIT-SEEKING ACTIVITY ARE DEDUCTIBLE

Ever since the first income tax law was enacted in 1913, the various Revenue Acts have drawn a distinction between "business" and "personal" expenses. Thus, Section II B of the Income Tax Act of 1913, c. 16, 38 Stat. 167, authorized deduction of "the necessary expenses actually paid *in carrying on any business*, not including personal, living, or family expenses * * *" (emphasis added). In the 1939 Code, prior to 1942, the deduction provision was contained in Section 23(a)(1)(A) (App., *infra*, p. 43), which allowed a deduction for "[a]ll the ordinary and necessary expenses paid or incurred * * * in carrying on any trade or business."[12] Because of the words of limitation, "trade or business", used in Section 23(a)(1)(A), taxpayers who incurred expenses in non-

[12] This precise language dates back to Section 214(a)(1) of the Revenue Act of 1918, c. 18, 40 Stat. 1057.

trade or nonbusiness profit-seeking activities, such as looking after one's own security investments, were denied a deduction because their expenses were not "paid or incurred * * * in carrying on any trade or business." See *Higgins* v. *Commissioner*, 312 U.S. 212; *City Bank Co.* v. *Helvering*, 313 U.S. 121; *United States* v. *Pyne*, 313 U.S. 127.

It was "[t]o change that result" (*Lykes* v. *United States*, 343 U.S. 118, 121) that Congress added, in 1942, the present subsection (a)(2) to Section 23 of the 1939 Code.[13] In order to correct the "inequity" of making "nontrade or nonbusiness income" taxable but not allowing "nontrade or nonbusiness expenses" to be deducted,[14] Congress allowed a deduction in the new subsection (a)(2) for "all the ordinary and necessary expenses paid or incurred" (1) "for the production or collection of income" or (2) "for the management, conservation, or maintenance of property held for the production of income." See *McDonald* v. *Commissioner*, 323 U.S. 57, 61. Except for technical changes, this language in Section 23 (a)(2) is still retained in the 1954 Code in Sections 212(1) and (2) (App., *infra*, p. 44).[15]

Section 23(a)(2) was characterized by this Court in *Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 373, 374, as being "comparable and *in pari materia*

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[13] The addition was made by Section 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798.

[14] H. Rep. No. 2333, 77th Cong., 2d Sess., p. 46 (1942-2 Cum. Bull. 372, 410); see, also, 3 Hearings on the Revenue Revision of 1942 Before the House Committee on Ways and Means, 77th Cong., 2d Sess., pp. 2801–2803, 3291; 88 Cong. Rec. 6376.

[15] The language in Section 23(a)(1) has also been retained in the 1954 Code in Section 162 (App., *infra*, p. 44).

with § 23(a)(1)" in that it provided "for a class of nonbusiness deductions coextensive with the business deductions allowed by § 23(a)(1), except for" the requirement that the expenses be incurred in a "trade or business". Thus, as the Committee Reports stated, "except for the requirement of being incurred in connection with a trade or business," a deduction under Section 23(a)(2) was to be "subject * * * to all the restrictions and limitations that apply in the case of the deduction under Section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business." H. Rep. No. 2333, 77th Cong., 2d Sess., p. 75 (1942–2 Cum. Bull. 372, 430); S. Rep. No. 1631, 77th Cong., 2d Sess., p. 88 (1942–2 Cum. Bull. 504, 571); quoted in *McDonald* v. *Commissioner, supra,* 323 U.S. at 62, n. 4; *Lykes* v. *United States, supra,* 343 U.S. at 122, n. 7; see Treasury Regulations 111, Sec. 29.23(a)–15(b); Treasury Regulations 118, Sec. 39.23(a)–15(d), App., *infra,* p. 44. Since Section 23(a)(1)(A) applied only to expenses incurred "in carrying on" a trade or business, Section 23(a)(2) was also only to apply to expenses incurred "in carrying on," or engaging in, a nontrade or nonbusiness profit-seeking activity. See *McDonald* v. *Commissioner, supra,* 323 U.S. at 62; *Trust of Bingham* v. *Commissioner, supra,* 325 U.S. at 374, 375.

The effect of the amendment was explained by the Court in *McDonald* v. *Commissioner, supra,* 323 U.S. at 61–62 (emphasis added): "[Since] Congress adopted the * * * [new subsection] for the restricted purpose" of allowing "deductions *from profitable*

transactions not covered by the statutory concept of 'business' income * * *," Congress "merely enlarged the *category of incomes* with reference to which expenses were deductible * * * [but] did not enlarge the *range of allowable deductions* of 'business' expenses." See, also, *Trust of Bingham* v. *Commissioner, supra,* 325 U.S. at 373–374. In other words, Section 23(a)(2) was to permit only "the deduction of some, but not all, of the nontrade and nonbusiness expenses of an individual taxpayer" (*Lykes* v. *United States, supra,* 343 U.S. at 121–122); nothing in the legislative history of the subsection indicated that "Congress sought to make such a change of policy as would authorize widespread deductibility of personal, living or family expenditures in the face of [Section 24(a)(1)]" (*id.* at 122; see *Lewis* v. *Commissioner*, 253 F.2d 821, 825 (C.A. 2d)).

Since the deductions under subsection (a)(2) were limited to expenses incurred in carrying on a nontrade or nonbusiness profit-seeking activity, the expenses could neither be classified as "trade or business" expenses in the technical sense or as "personal" expenses. But since the expenses were to be incurred in a profit-seeking activity, they could at least be characterized as being more akin to "business" expenses in the nontechnical sense than to "personal" expenses. Section 23(a) as a whole, therefore, still retains its original character as a provision for the deduction of "business"—or at least "business"-type—expenses; subsections (a)(1) and (a)(2) together provide that "insofar as an individual taxpayer engages in *a profit-seeking activity,* he may deduct from gross income the

expenses incurred *in that activity*, limited only by the requirement that the expenses be both 'ordinary and necessary' * * *'' (*Lewis* v. *Commissioner, supra*, 253 F. 2d at 825 (emphasis added)).

B. LEGAL EXPENSES INCURRED BY A HUSBAND IN CONNECTION WITH THE PROPERTY-SETTLEMENT ASPECT OF A DIVORCE PROCEEDING ARE NOT INCLUDED IN CARRYING ON, OR ENGAGING IN, A PROFIT-SEEKING ACTIVITY; RATHER, THEY ARE PERSONAL IN NATURE AND ARE THEREFORE NOT DEDUCTIBLE

1. According to the tests established by this Court, the deductibility of legal expenses "turns * * * upon the nature of the activities to which * * * [the legal expenses] relate" (*Lykes* v. *United States, supra*, 343 U.S. at 123; accord, *Commissioner* v. *Heininger*, 320 U.S. 467, 472). "It is the kind of transaction out of which the obligation arose * * * which * * * [is] crucial and controlling" (*Deputy v. du Pont*, 308 U.S. 488, 496); "* * * it is the origin of the liability out of which the expense accrues which is material" (*id.* at 494). The legal expenditures must be an expense "of" the profit-seeking activity (*Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593) or they must be incurred "in" that activity (*Lewis v. Commissioner, supra*, 253 F. 2d at 825); they must be expenses arising or "growing directly out of the conduct" of that activity (*Kornhauser* v. *United States*, 276 U.S. 145, 151).

Thus, in *Trust of Bingham* v. *Commissioner, supra*, this Court held that legal expenses incurred by trustees of a testamentary trust in contesting an income tax deficiency and winding up the trust were deductible under Section 23(a)(2) because the expenses were

considered to be "directly connected with or proximately result[ing] from the *conduct of the business*" and "an integral part of *carrying out the trust enterprise*" (325 U.S. at 374, 375 (emphasis added)). In *McDonald* v. *Commissioner, supra,* however, campaign expenditures incurred by a judge in running for reelection were held to be nondeductible under Section 23(a)(2) because "they were not incurred in 'carrying on' his 'business' of judging" (323 U.S. at 62).

Similarly, in *Lykes* v. *United States, supra,* the taxpayer was not allowed a deduction for attorney fees incurred in contesting a gift-tax deficiency for gifts of stock in a closely-held family corporation to his children because the origin of the legal expenses was in the gift, a personal matter, and not in a profit-seeking activity with which Section 23(a)(2) is concerned.[14] In answering the taxpayer's contentions that the attorneys' fees had been incurred in an attempt to conserve his property from the asserted gift-tax liability, the Court stated (343 U.S. at 125):

> Legal expenses do not become deductible merely because they are paid for services which relieve a taxpayer of liability. That argument * * * would mean that the expense of defending almost any claim would be deductible by a taxpayer on the ground that such defense was

[14] The specific result of the *Lykes* case was altered by the addition of subsection (3) to Section 212 of the 1954 Code, which allows deductions "in connection with the determination, collection, or refund of any tax"—the scope of which provision is now being considered in *Davis* v. *United States*, No. 268, this Term. The amendment did not affect the application of *Lykes* to subsection (a)(2) of Section 23 of the 1939 Code or subsections (1) and (2) of Section 212 of the 1954 Code.

> made to help him keep clear of liens whatever income-producing property he might have. For example, it suggests that the expense of defending an action based upon personal injuries caused by a taxpayer's negligence while driving an automobile for pleasure should be deductible.

Although the Court recognized that every asserted liability, if justified, would have the effect of reducing income-producing resources of a taxpayer, and that expenditures for legal fees incurred to counteract, defeat, negotiate, or minimize such liabilities could be considered as relating to the "conservation" or "maintenance" of income-producing property, the Court rejected such an all-inclusive test of deductibility. Rather, it held that Section 23(a)(2) is to be applied "to expenses on the basis of their *immediate purposes* rather than upon the basis of the *remote contributions* [or the incidental effect] they might make to the conservation of a taxpayer's income-producing assets by reducing his general liabilities" (343 U.S. at 125 (emphasis added)). The mere threat of consumption of the taxpayer's income-producing property was not enough (*id.* at 126). See Treasury Regulations on Income Tax (1954 Code), Sec. 1.212-1 (m), App., *infra*, p. 46.

2. From the tests established by this Court, it is clear that legal expenses incurred during the course of a divorce proceeding—whether they be to contest the divorce, to resist the liability for alimony, or to negotiate a property settlement—are not "ordinary and necessary expenses paid * * * for the * * * conservation * * * or maintenance of property held

for the production of income" within the meaning of Section 23(a)(2) of the 1939 Code or Section 212(2) of the 1954 Code. The most that can be said for those legal expenses is that they are used to minimize the material effect of the divorce by holding to a minimum the amount necessary to effectuate the property settlement. Even though the expenditures may benefit the husband by protecting his income-producing property, the protection of the property is merely an incidental effect of the legal expenses. The origin and the immediate purpose of the legal expenses are not in the husband's trade or business or profit-seeking activity. The expenses are not incurred in, are not a part of, and do not arise or grow out of the conduct of the husband's profit-seeking activity."[17] Rather, the legal expenses connected with a divorce have their orgin in the marital rift or in the termination of the marital relationship, an obviously "personal" or "family" matter, within the meaning of Section 24(a)(1) of the 1939 Code and Section 262 of the 1954 Code (see Treasury Regulations 118, Sec. 39.24(a)-1; Treasury Regulations on Income Tax (1954 Code), Sec. 1.262-1(b)(7)).

3. The "personal" origin of the legal expenses connected with a divorce is indicated by the facts of the present cases. In *Gilmore*, the reasons

[17] Of course, when legal expenses are actually incurred in protecting a business or other profit-seeking activity they may be deductible under Section 23(a) if they have their origin in the conduct of the activity. See *Commissioner* v. *Heininger*, 320 U.S. 467.

given for the allowance of the deduction were that the taxpayer-husband faced a possible loss of income, a possible loss of 50 percent or more of his stock in his automobile dealerships, and could have lost his dealership franchises (G.R. 117); that he "was fighting not only to protect his income-producing property, but to prevent the loss of his salary as well" (G.R. 117); that "[i]t is not too difficult to imagine that an irate ex-wife, if she gained control of a corporation, would dispose of her ex-husband as president" (G.R. 117); and that "[t]he sensational nature of the divorce charges of adultery and misconduct, brought by Dixie Gilmore, were published in the local papers" and "[t]his adverse publicity created a real fear that General Motors might terminate" taxpayer's franchises "if the allegations were established and a divorce granted to the wife" (G.R. 118). In brief, the legal expenses were incurred by the taxpayer-husband to defend and protect himself against the consequences of his wife's charges of misconduct and adultery. The origin of the expenses was of an exceptionally personal character.

In *Patrick*, an agreement was reached whereby the husband acquired the wife's shares for a price, thus assuring his continuing control of the company. Significantly, an important condition was attached—that the children were to have a remainder interest in all of the husband's shares, both those previously held and those acquired under the settlement purchase. As to the real property involved, the husband completely relinquished his 80 percent undivided interest, placing it in trust for the wife during her life, with

the remainder over to the children. (P.R. 5, 8–12.) It seems patent, therefore, that the settlement, although completely amicable, was nevertheless an adjustment of intra-familial obligations, typically a matter far removed from the subject of Section 23(a)(2) of the 1939 Code or Section 212(2) of the 1954 Code.

C. IN FOLLOWING THE CRITERIA FOR DETERMINING DEDUCTIBILITY UNDER THE LINE OF AUTHORITY WHICH ORIGINATED WITH *BAER* V. *UNITED STATES*, THE COURTS BELOW HAVE VIOLATED THE TESTS AND PRINCIPLES FOR DETERMINING DEDUCTIBILITY ENUNCIATED BY THIS COURT.

By distinguishing (G.R. 117; P.R. 63–64) this Court's decision in *Lykes* v. *United States*, *supra*, and by adhering to the criteria established in the line of authority which originated with the Eighth Circuit's decision in *Baer* v. *United States*, 196 F. 2d 646, the courts below failed to follow the tests and principles enunciated by this Court for determining the deductibility of legal expenses incurred by a husband in connection with the property-settlement aspect of a divorce proceeding and held those expenses to be deductible under Section 23(a)(2) of the 1939 Code and Section 212(2) of the 1954 Code.[13]

[13] Prior to the present cases, the *Baer* doctrine was followed by the Sixth Circuit (*Bowers* v. *Commissioner*, 243 F. 2d 904) and the Fifth Circuit (*Owens* v. *Commissioner*, 275 F. 2d 251); rejected by the Second Circuit (*Lewis* v. *Commissioner*, 253 F. 2d 821) and the Tax Court (*Douglas* v. *Commissioner*, 33 T.C. 349; *Estate of Walsh* v. *Commissioner*, 28 T.C. 1274; *Joyce* v. *Commissioner*, 3 B.T.A. 393, 397); and distinguished or not followed by the Third Circuit (*Smith's Estate* v. *Commissioner*, 208 F. 2d 349) and the Ninth Circuit (*Howard* v. *Commissioner*, 202 F. 2d 28; *Tressler* v. *Commissioner*, 228 F. 2d 356; *Harris* v. *United States*, 275 F. 2d 238). The Fourth Circuit purported to follow the *Baer* case in *Patrick*. Although the

The test adopted by the court of appeals in *Baer*, and by those courts which have followed *Baer* (see *Bowers* v. *Commissioner*, 243 F. 2d 904 (C.A. 6th); *Owens* v. *Commissioner*, 273 F. 2d 251 (C.A. 5th); *McMurtry* v. *United States*, 132 F. Supp. 114 (C. Cls.)), may be articulated in the following way: although legal expenses connected with a divorce proceeding are ordinarily nondeductible as being "personal" expenses (see Treasury Regulations 118, Sec. 39.24(a)-1; Treasury Regulations on Income Tax (1954 Code), Sec. 1.262-1(b)(7)), they nevertheless may be deducted as "ordinary and necessary expenses paid * * * for the * * * conservation * * * or maintenance of property held for the production of income," provided that (1) the husband does not contest the divorce and (2) concedes his liability for alimony, but incurs the legal expenses, (3) because of the urgency of resisting his wife's demands (4) with respect to specific income-producing property (5) out of which he earns his livelihood, in order to arrive at a satisfactory adjustment of his liability in a property settlement.[19]

Court of Claims purported to adhere to *Baer* in *Gilmore* and in *McMurtry* v. *United States*, 132 F. Supp. 114, it did not apply *Baer* in *Davis* v. *United States*, 287 F. 2d 168, now pending on certiorari on other issues, Nos. 190 and 268, this Term.

[19] In *Baer*, a portion of the husband's legal expenses was held to be deductible under Section 23(a)(2) as having been paid for the conservation or maintenance of income-producing property. In that case, the taxpayer-husband had been sued for divorce by his wife who, in addition to other matters, demanded from him a lump sum payment in excess of $1,000,000. Satisfaction of the wife's demands would have required the husband to sell a considerable portion of his stock in a corporation

1. *Baer erroneously fails to distinguish between the incidental effect and the origin of the expenses.*—The basic flaw in the test adopted in *Baer* is that it fails to distinguish between (1) the incidental effect of the legal expenses, and their remote contribution to the conservation or maintenance of the husband's position with respect to certain specific income-producing property and (2) the nature and kind of transaction out of which the obligation arises and the origin of the liability out of which the legal expenses accrue, *i.e.*, the marital rift and divorce. By holding that the legal expenditures "had a proximate and direct relation *to* the conservation and maintenance of specific property * * *" (196 F. 2d at 651 (emphasis added)), the court in *Baer* completely ignored the basic criterion established by this Court for deduction under Sections 23(a)(2) and 212(2), that the legal expense must have their origin in or be "directly connected with or proximately result * * * from the conduct of the business" of holding the specific property for the production of income (*Trust of Bingham* v. *Commissioner, supra,* 325 U.S. at 374).

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which he controlled and from which his income was mainly derived in the form of salary and dividends. Although the husband did not contest the divorce or resist his liability for alimony, he did resist his wife's efforts to obtain a gross settlement because he was concerned about the possibility of breaking up his block of stock in the corporation and the effect it would have on his control and future in the business. Through the efforts of his attorneys, a property settlement was worked out by which the husband was placed in a position to meet his obligations to his wife and yet remain in control of the corporation and of his stock in the corporation.

2. *Baer erroneously emphasizes the urgency of resisting the wife's demands.*—The second basic error in the test formulated in *Baer* is that the deductibility of the legal expenses is supposed to stem in part from the urgency of resisting the demands which the wife makes with respect to specific income-producing property in satisfaction of the husband's property-settlement liabilities. Presumably the court believed that the urgency of resisting the wife's demands is directed toward the conservation or maintenance of the property. But this Court in *Lykes* specifically held that neither the "size" of the liability nor the "urgency" of resisting it "determined its character" (343 U.S. at 125); rather, deductibility turned "upon the nature of the activities to which * * * [the legal expenses] relate[d]" (*id.* at 123).

3. *Baer erroneously distinguishes between specific income-producing property and general assets.*—A further misconception in *Baer* is that it makes a distinction between the husband's expenditure of legal fees in order to protect specific income-producing property out of which he earns his livelihood and the husband's expenditure of legal fees in order "to hold to a minimum the amount necessary to effect a property settlement" (*Davis* v. *United States*, 287 F. 2d 168, 172 (C. Cls.)). In the former case, according to *Baer*, the legal expenses are deductible under Section 23(a)(2) of the 1939 Code and Section 212(2) of the 1954 Code, but, in the latter case, the legal expenses are "personal" within the meaning of Section 24(a)(1) of the 1939 Code and Section 262 of the

1954 Code, and are therefore not deductible. In *Lykes*, this Court noted with displeasure the "substantial uncertainty and inequity [which] would inhere" in a rule under which one taxpayer "might be permitted to deduct from his taxable income the same expense for precisely the same services as those upon which his less well-to-do neighbor would have to pay a tax * * *" (343 U.S. at 126). Whether liability in a property settlement is resisted or merely adjusted, or whether the liability relates to specific income-producing property or merely to the general assets of the taxpayer, the source and origin of the legal expenses in connection with the property settlement are the same—the marital rift and the termination of the marital relationship. Despite this fact, *Baer* would allow some husbands a deduction for their legal expenses and others not, depending on the specific nature of the husband's wealth and the specific claims of the wife. Such a distinction has no place under our present tax statutes.

4. *Baer draws an impracticable line of demarcation for determining deductibility.*—Beyond the distinction between specific income-producing property and general assets, *Baer* attempts to draw an impracticable line of demarcation between what is and what is not deductible—one which can only engender confusion in its application and which has in fact engendered confusion in the present cases.

(*a*) In *Gilmore*, the Court of Claims allowed the taxpayer-husband a deduction of 80 percent of the legal expenses he incurred in contesting both the divorce and his liability for the settlement of property,

on the theory that defending and protecting himself against the consequences of his wife's charges of misconduct and adultery were related to the conservation of his income-producing property. In so doing, the court recast the test in *Baer* to allow a deduction under Section 23(a)(2) "when the facts of a particular case clearly indicate that the property, around which the controversy evolves, is held for the production of income and without this property the litigant might be denied not only the property itself but the means of earning a livelihood * * *" (G.R. 119).

(*b*) In *Patrick*, on the other hand, the Fourth Circuit distinguished the *Lykes* and *Lewis* cases from the *Baer* case on the ground that in *Lykes* "[t]he fees were incurred in contesting * * * [the tax] deficiency or in resisting liability" and in *Lewis* the legal "fees were spent in resisting legal separation proceedings and liability," whereas, in *Baer*, the fees were spent in negotiating the property settlement (P.R. 64). The Fourth Circuit then went off in the opposite direction, however, in relying on the *Baer* decision but applying it to a completely amicable divorce and property settlement in which there was no immediate threat by the wife to any specific income-producing property and in which even the incidental effect of the legal fees had no relevance to the "conservation" or "maintenance" of income-producing property.

In *Patrick*, the only income-producing property of the taxpayer which was involved in the settlement negotiations was his 28 percent stock interest in the Herald Publishing Company and an undivided 80 percent interest in the real estate which was leased to

that company. The wife owned a 28 percent stock interest in the publishing company, and the children the remaining interest. The wife also owned a 20 percent interest in the real estate.

"Because of the family unity which had existed" (P.R. 65) prior to the marital discord, the taxpayer had been able to control the publishing company and thus insure his positions as corporate president and treasurer and as editor and publisher of the newspaper, from which he derived salaries. The imminent divorce, which destroyed the family unity, meant that the taxpayer could have lost his control of the publishing company, and that, as the court below stated (P.R. 65), the wife could have acquired the right to partition or force a sale of the income-producing property which housed the publishing company. But the wife was satisfied that the management of the corporation and the editorial policies of the newspaper were sound, and she was not disposed to assume the responsibility of providing the corporation with new competent leadership and of continuing the newspaper (P.R. 50–51).

The negotiations with respect to the property settlement culminated in an agreement under which the taxpayer purchased his wife's 28 percent stock interest in the publishing company and relinquished his 80 percent undivided interest in the real estate leased to the publishing company. His purchase of his wife's 28 percent stock interest was subject to conditions requiring him to turn over the sale proceeds to the children if he sold the stock, and, if no sale occurred, the stock was to pass automatically to the

children upon the taxpayer's death. (P.R. 11–12.) The taxpayer's 80 percent undivided interest in the real estate, along with the wife's 20 percent undivided interest, was put in trust for the payment of the net income to the wife for life, with remainders over to the children (P.R. 8–10.)

Clearly, the taxpayer's relinquishment of his 80 percent undivided interest in the real estate leased to the publishing company hardly qualifies as a "conservation" or "maintenance" of income-producing property. Cf. *Lykes* v. *United States, supra; Trust of Bingham* v. *Commissioner, supra.* Nor did the court below hold otherwise; rather, it stressed that the taxpayer might have lost control of the publishing company (P.R. 65–66) and concluded, therefore, that all of the taxpayer's income-producing properties were "in great peril" (P.R. 65) and in "danger" (P.R. 66) unless and until a satisfactory property settlement agreement was concluded. But the "peril" or "danger" was minimal and, more important, related only to the possible loss of the taxpayer's control of the publishing company—which he previously had not because of a controlling interest, but "[b]ecause of the family unity which had existed" (P.R. 65). The "danger" was not that he would lose his 28 percent stock interest in the publishing company, but that, because of the break-up of the family unity, he might lose his income from the publishing company by losing his salaried positions with it. Perhaps the court below was aware of this fact, for it stated at one point (P.R. 66 (emphasis added)) that the legal fees were spent for services

"designed to find a means in which the taxpayer could meet these liabilities [to his wife and children] without destroying his *income* and his income-producing *status*". In any event, as the court below conceded (P.R. 65), the wife made no demands and took no action to endanger taxpayer's income-producing property as such. Therefore, the attorneys' fees paid by the taxpayer for services in negotiating the settlement agreement—although paid "to find a means in which the taxpayer could meet these liabilities" to his wife and children (P.R. 66)—did not even have the incidental effect of, or make a remote contribution to, conserving income-producing property on which *Baer* and similar cases had erroneously predicated the allowance of a deduction under Section 23(a)(2). In fact, contrary to the assumption of the court below and unlike the situation in the typical *Baer*-type case, the taxpayer was not even dependent upon the publishing company for a livelihood. His gross income for the taxable year was over $55,000, of which $15,000 consisted of salaries, and $5,400 consisted of dividends, both received from the publishing company (P.R. 5, 25–26). Accordingly, less than half of his income was from the publishing company (P.R. 26).

In essence, the Fourth Circuit extended the erroneous criteria of *Baer* to reach an even more paradoxical result. On the one hand, the court placed great emphasis upon maintenance of the taxpayer's control of the publishing company, purporting to be concerned with the management, conservation, or maintenance of his specific income-producing property. On the other

hand, the court completely ignored the fact that, under the settlement agreement, the taxpayer purchased his wife's 28 percent stock interest in the publishing company and thereby *acquired* the stock control of the company which he did not have previously.

D. EVEN IF THE PERSONAL NATURE OF THE CONTESTED LEGAL EXPENDITURES WERE TO BE IGNORED, A PORTION OF THE EXPENDITURES IN *GILMORE* AND ALL OF THE EXPENDITURES IN *PATRICK* WOULD BE NONDEDUCTIBLE AS BEING CAPITAL IN NATURE

1. In *Gilmore*, even if the contested legal fees[20] were not considered personal expenses, a portion of the fees would have to be considered as nondeductible capital expenditures. The only substantial income-producing property which could have been affected by the divorce proceedings was the husband's stock in his three automobile dealerships. His possible loss of stock control and income from the businesses stemmed from his wife's claim that the $600,000 appreciation in the value of his stock was community property. (See G.R. 130–131.) "The question of community property was an important one during the divorce proceedings" (G.R. 114). But these possible losses—possible because the greater share of the community property might have been awarded to the wife if she had obtained a divorce on her misconduct charges—

[20] In *Gilmore*, 20 percent of the fees were considered personal, as relating directly to the divorce contest itself (see the Statement, *supra*, pp. 6–7); of the 80 percent remaining, only that portion relating to the $600,000 appreciation of stock could be considered as capital in nature.

would not occur if the $600,000 appreciation in the value of the stock was not community property. Thus, "[i]n preparation for and during the trial of the divorce suit, Don Gilmore's attorneys devoted considerable effort in establishing that no portion of the increase in the value of his stock constituted community property" (G.R. 133), and, therefore, a portion of the legal expenses held to be deductible by the court below was incurred by the taxpayer in the defense of title to property. Expenditures for that purpose constitute capital expenditures which are nondeductible. See Treasury Regulations 118, Sections 39.23(a)-15(e), (k), 39.24(a)-2(a), App., *infra* pp. 44–45; *Harris* v. *United States*, 275 F. 2d 238 (C.A. 9th); *Shipp* v. *Commissioner*, 217 F. 2d 401 (C.A. 9th). In fact under circumstances strikingly similar to those in the present case, the Ninth Circuit, in *Harris* v. *United States*, *supra*, 275 F. 2d at 240, denied the taxpayer's claim to a deduction under Section 23(a)(2) on the ground that "the attorney fees were paid to resist the wife's claim that there was community property."

2. Similarly, in *Patrick*, even if the personal nature of the contested legal fees [21] were to be ignored, the fees

[21] In *Patrick*, the $4,000 in fees paid for handling the divorce were disallowed as being personal in nature and the $800 in fees charged to the wife, but paid by the husband, with respect to the real estate was never claimed as a deduction (see the Statement, *supra*, p. 10); all of the remaining fees could have been considered as capital in nature.

might then be considered nondeductible capital expenditures. If it be assumed that the property settlement agreement were an arm's-length agreement between two unrelated parties which involved nothing more than the two income-producing properties of the taxpayer, *i.e.*, his 28 percent stock interest in the publishing company and his 80 percent undivided interest in the real estate, then the portion of the $16,000 which the taxpayer paid to his own attorneys for rearranging the stock ownership and control of the publishing company (P.R. 47) could be considered to have been paid for services which resulted in the taxpayer's purchase of his wife's 28 percent stock interest in the company. But "[e]xpenses incurred to acquire title to property are capital in nature and are not deductible * * *." *Lewis* v. *Commissioner, supra,* 253 F. 2d at 828; see Treasury Regulations on Income Tax (1954), Section 1.212–1(q), App., *infra,* pp. 45, 46; cf. *Welch* v. *Helvering,* 290 U.S. 111.

Moreover, the $3,200 in attorneys' fees allocated for the handling of the real estate (P.R. 47) was for services performed in disposing of the taxpayer's 80 percent undivided interest in the real estate. Except with respect to dealers, expenses incurred in connection with the disposition of property are normally deemed to be capital in nature and treated as an offset against the sales price, rather than as expenses. See *Spreckels* v. *Commissioner,* 315 U.S. 626; *Munson* v. *McGinnes,* 283 F. 2d 333 (C.A. 3d).

II

THE LEGAL FEES PAID BY THE TAXPAYER IN *PATRICK* TO HIS WIFE'S ATTORNEYS PURSUANT TO THE SETTLEMENT AGREEMENT AND DIVORCE DECREE ARE NOT DEDUCTIBLE UNDER SECTION 212(2) OF THE INTERNAL REVENUE CODE OF 1954

Under the settlement agreement incorporated into the divorce decree, the taxpayer in *Patrick* was required to pay the legal fees incurred by his wife in the divorce proceeding, which totalled $12,000 (P.R. 47). The Fourth Circuit held that the wife's share of the total of $16,000 in attorneys' fees allocated to the rearranging of stock ownership and control of the Herald Publishing Company, just like the taxpayer's share of legal fees paid to his own attorneys, was deductible under Section 212(2) (P R. 66). The court's explanation for his incongruous holding (P.R. 66) was that "[t]he taxpayer's liability for his legal fees and the legal fees for his wife would not have been incurred except for the necessity of the long and extended negotiations culminating in" the property settlement agreement; that the fees were incurred solely for the purpose of preserving, maintaining and conserving the taxpayer's income-producing property; that the "only test of deductibility * * * is whether or not the expenses were reasonable and proximately related to the management, conservation and maintenance of income-producing property"; and that "[i]t makes no difference to whom they are paid."[22]

[22] The court below relied upon *Owens* v. *Commissioner*, 273 F. 2d 251 (C.A. 5th), as authority for its holding. But in *Owens*, the Fifth Circuit, following *Baer*, held that the hus-

The court's holding with respect to the wife's legal expenses demonstrates its erroneous view of Section 212(2) perhaps even more than its holding that the taxpayer was entitled to deduct his own attorneys' fees. A contention similar to that of the present taxpayer was summarily rejected by the Second Circuit in *Lewis* v. *Commissioner, supra*, 253 F. 2d at 828. Obviously, the wife's attorneys' fees were a part of what the taxpayer paid in satisfaction of his liability to his wife by virtue of the divorce. Thus, it would have been more logical for the taxpayer to have claimed that his wife's attorneys' fees were deductible as alimony, although such a contention would have had to be rejected because the legal fees were not in the form of periodic payments. See *Baer* v. *Commissioner, supra*, 196 F. 2d at 649; *Norton* v. *Commissioner*, 192 F. 2d 960 (C.A. 8th); *Richardson* v. *Commissioner*, 234 F. 2d 248 (C.A. 4th). See, also, n. 11, *supra*, p. 18.

Moreover, all the reasons for disallowing the deduction for the taxpayer's own attorneys fees are equally applicable to his wife's attorney fees. Even if the wife's attorneys' fees had not been paid by the taxpayer merely in satisfaction of his liability to his wife, the fees would have been nonetheless nondeductible, for they were personal expenses, having had their origin in the termination of the marital relationship, instead of the "business"-type or profit-seeking-type of expense for which Section 212(2) allows a

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band was entitled to deduct the fee which he paid to his wife's attorney *for services rendered to him, not to her*, even though it expressed some concern with the propriety of an attorney acting as a representative of two supposedly adversary parties.

deduction (see *supra*, pp. 23–28, 30). Furthermore, the wife's attorneys' fees could hardly have had even a remote relation to the "conservation" or "maintenance" of the taxpayer's income-producing property, since they were incurred by the wife in furtherance, not of the taxpayer's interests, but of her own interests as an adversary in the divorce proceeding. Cf. *Magruder* v. *Supplee*, 316 U.S. 394. Even if the wife's attorneys' fees had been incurred for the taxpayer's benefit, the fees would have been capital expenditures incurred in the acquisition and disposition of title to property (see *supra*, pp. 38–39). The allowance of the deduction of the wife's legal fees highlights how far the Fourth Circuit below has gone in misconceiving or ignoring the language and purpose of the statute.

CONCLUSION

For the foregoing reasons, the judgments of the courts below should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.):

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

(2) *Non-trade or non-business expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

* * * * *

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

(1) [as amended by Sec. 127(b) of the Revenue Act of 1942 *supra*] Personal, living, or family expenses * * * [with certain exceptions].

* * * * *

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

* * * * *

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income * * *.

* * * * *

SEC. 262. PERSONAL, LIVING, AND FAMILY EXPENSES.

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

Treasury Regulations 118:

SEC. 39.23(a)-15 *Nontrade or nonbusiness expenses.* * * *

* * * * *

(d) Except for the requirement of being incurred in connection with a trade or business, a deduction under this section is subject to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business. This includes restrictions and limitations contained in section 24. * * *

(e) Capital expenditures, and expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and

are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income * * *, are not allowable as nontrade or nonbusiness expenses. * * *

* * * * *

(k) Expenditures incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of * * *) * * * constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible * * *.

* * * * *

SEC. 39.24(a)-1 *Personal and family expenses.*—* * * Generally, attorneys' fees paid in a suit for divorce or separate maintenance are not deductible. However, the part of an attorney's fee paid in a divorce or separate maintenance proceeding which is properly attributable to the production or collection of amounts includible in gross income under section 22(k) is deductible under section 23(a)(2). * * *

SEC. 39.24(a)-2 *Capital expenditures.*—(a) *Expenditures except non-depreciable mine development expenditures.*—* * * The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. * * *

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.212-1 *Nontrade or Nonbusiness Expenses.* * * *

* * * * *

(c) Expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income * * *

are not allowable as nontrade or nonbusiness expenses. * * *

* * * * *

(m) An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability.

(n) Capital expenditures are not allowable as nontrade or nonbusiness expenses. * * *

* * * * *

SEC. 1.262–1 *Personal, Living, and Family Expenses*—(a) *In general.*—In computing taxable income, no deduction shall be allowed, except as otherwise expressly provided in chapter 1 of the Internal Revenue Code of 1954, for personal, living, and family expenses.

(b) *Examples of person, living, and family expenses.*—Personal, living, and family expenses are illustrated in the following examples:

* * * * *

(7) Generally, attorney's fees and other costs paid in connection with a divorce, separation, or decree for support are not deductible by either the husband or the wife. However, the part of an attorney's fee and the part of the other costs paid in connection with a divorce, legal separation, written separation agreement, or a decree for support, which are properly attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the wife under section 212.

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